

Message Text

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ACTION EB-04

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C O N F I D E N T I A L TOKYO 14820

E.O. 11652: GDS

TAGS: EFIN, JA

SUBJECT: TOKYO FOREX MARKET DEVELOPMENTS

LIMDIS GREENBACK

PASS TREASURY FOR UNDERSECRETARY PAUL A. VOLCKER

SUMMARY: BOJ DROPPED DOLLAR INTERVENTION RATE FROM YEN 275 TO YEN 280 PRIOR TO OPENING FOREX MARKET TUES, NOV 13. HOPES OF STABILIZING MARKET PSYCHOLOGY BACKFIRED AS DISCOUNT ON FORWARD RATE ALSO DROPPED BY FIVE YEN, THUS MAINTAINING STRONG ARBITRAGE INCENTIVE WHICH IMPORTANT FACTOR IN RECENT SPOT DOLLAR DEMAND. IN EFFORT TO SALVAGE SITUATION, BOJ TODAY ANNOUNCED CHANGES IN (1) REGULATIONS LIMITING DOLLAR USANCE CREDITS (BOJ/MOF SWAPS) AND (2) LIMITATION ON INVESTMENTS IN U.S. TREASURY BILLS (BUT NOT IN EURODOLLAR MARKET) OF DOLLAR PROCEEDS FROM ARBITRAGE OPERATIONS JAPANESE BANKS, SECURITIES HOUSES AND LIFE INSURANCE COMPANIES. EVIDENTLY SITUATION CONSIDERED SERIOUS ENOUGH SO THAT MOF CALLED JAPANESE IMF DIR TO APPRAISE HIM OF MARKET DEVELOPMENTS WITH REQUEST TO PASS ON TO FINACIAL MINISTER AT JAPANESE EMBASSY. FOLLOWING ARE DETAILS OF CURRENT SITUATION BASED ON FINATT TALKS WITH OFFICIALS, BANKS AND TRADING COMPANIES.

1. BOJ POLICY GROUP MADE DECISION BEFORE MARKET OPENING NOV 13 TO ALLOW SPOT DOLLAR RATE TO MOVE TO YEN 280 LEVEL
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BEFORE EFFECTING ANY INTERVENTION. THIS DONE IN ANTICIPATION OF SERIOUS SHORTAGE OF DOLLARS EXPECTED IN MARKET THIS WEEK. THIS TACTIC TAKEN IN HOPE THAT SUCH MOVE WOULD QUELL ANY SIGNIFICANT SPECULATIVE ACTIVITY (I.E. THAT SPOT DOLLAR

RATE WOULD RISE TO HIGH ENOUGH LEVEL SO THAT FORWARD RATES WOULD NOT MOVE TO ANY SIGNIFICANT PREMIUM). RELIABLE BOJ CONTACT STATED END OF TRADING DAY HIS DISMAY AT THIS MOVE, INTIMATING THAT POLICY OF "CLUMSY INTERVENTION" IN ESSENCE BACKFIRED. ONCE SPOT DOLLAR RATE REACHED YEN 280 LEVEL DURING MORNING SESSION, BOJ BEGAN TO INTERVENE, WHILE FORWARD RATES MOVED UP TO SIGNIFICANT PREMIUM. TRADING COMPANY REPRESENTATIVES, WHO PREVIOUS HAD STATED BELIEF THAT YEN 276-277 LEVEL WAS MAXIMUM APPRECIATION OF DOLLAR GOVT WOULD ALLOW, NOW HAVE REVISED THEIR THINKING AND BELIEVE DOLLAR RATE MAY GO HIGHER THAN YEN 280 PARITY.

2. DOLLAR IN SPOT MARKET TRADED ON MON, NOV 12 AT YEN 275.08 ON VOLUME OF \$146 MIL. FORWARD RATES ON MON ALSO REMAINED STABLE, AT YEN 281.40 FOR THREE-MONTH FORWARD AND YEN 281.00 FOR SIX-MONTH FORWARD, WITH TOTAL VOLUME REGISTERING \$117.7 MIL. TODAY, NOV 13, SPOT DOLLAR RATE ROSE IN MORNING SESSION TO LEVEL OF YEN 280.00 WITH BOJ INTERVENTION BEGINNING AT THAT RATE. TOTAL VOLUME IN THE SPOT MARKET WAS \$235 MIL, WITH CENTRAL BANK INTERVENTION ACCOUNTING FOR NEARLY \$200 MIL (VERSUS \$80 MIL ON NOV 12). FORWARD RATES TODAY JUMPED SHARPLY, WITH THREE-MONTH FORWARD (FEB DELIVERY) CLOSING AT YEN 292.30 PER DOLLAR. TOTAL VOLUME IN THE FORWARD MARKET WAS \$103.2 MIL.

3. BOJ OFFICIAL INDICATED THAT LITTLE PURE SPECULATIVE TRADING GENERATED BY FOREIGN EXCHANGE BANKS SINCE RECENT TIGHT MONETARY POLICY HAS CAUSED SHORTAGE OF YEN FUNDS AVAILABLE. SINCE ONLY WAY BANKS IN TIGHT LIQUIDITY SITUATION CAN GET FUNDS FROM BOJ, CENTRAL BANK CAN MONITOR USE OF SUCH FUNDS AND WILL NOT LEND FOR SPECULATIVE PURCHASES. KNOWLEDGEABLE U.S. BANKER (STALLKAMP, BANKERS TRUST), HOWEVER, INDICATES TRUST AND SMALL BANKS AND NON-BANK FINANCIAL INSTITUTIONS TAKING ADVANTAGE OF LUCRATIVE ARBITRAGE OPPORTUNITIES AVAILABLE. ONE EXAMPLE OF SUCH ACTIVITY GIVEN BY BOJ CONTACT WAS HEAVY PURCHASES LAST FRI AND MON THROUGH MAJOR SECURITIES HOUSES OF U.S. TREASURY BILLS. BOJ OFFICIAL INDICATES ANNUALIZED RATE OF APPROX 15 PERCENT ABLE TO BE GAINED BY CONFIDENTIAL

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PURCHASE OF SPOT DOLLARS, INVESTMENT IN HIGH-YIELDING U.S. TREASURY BILLS, WITH SALES OF THESE DOLLAR PROCEEDS IN FORWARD MARKET AT SIGNIFICANT PREMIUM. SAME OFFICIAL ALSO ADDED, HOWEVER, THAT AS OF MORNING, NOV 13 BOJ HAS CLOSED THIS LOOPHOLE AND WILL NOT ALLOW SUCH TRANSACTIONS UNDER FOREIGN EXCHANGE CONTROLS. HE SEEMS RESIGNED TO FACT, THOUGH, THAT SHREWD SPECULATORS WITH YEN FUNDS WILL FIND OTHER MEANS TO TAKE ADVANTAGE OF ARBITRAGE OPPORTUNITIES SO LONG AS THEY EXIST. MARKET DEMAND FOR DOLLARS ALSO EMANATING FROM EARLY REPAYMENT OF USANCE CREDITS (BOJ/MOF SWAPS). MOF RECOGNIZED FINATT COMMENT THAT THIS SOURCE OF DEMAND MERELY TO REPAY MOF CREDITS NO REASON TO LOWER INTERVENTION RATE. OFFICIAL RECOGNIZED THIS POINT AND

CONCEDED THAT RATE DEVELOPMENTS MERELY ACCELERATED DESIRE REPAY THESE CREDITS PROMPTLY. CONTRARY TO PREVIOUS FIRM POSITIONS, BOJ ANNOUNCED NEW "YEN USANCE CREDIT" EFFECTIVE NOV 21 DESIGNED TO SUBSTITUTE FOR PRESENT DOLLAR USANCE FINANCING INVOLVING BOJ CREDITS AND MOF SWAPS. UNLIKE JULY GULGE IN REPAYMENT OF OFFICIAL FORWARD COVER TO SMALL AND MEDIUM-SIZE JAPANESE BUSINESS, BOJ OFFICIAL EXPECTS ONLY \$300 MIL REPAYMENT OF OFFICIAL FORWARD COVER TO SMALL AND MEDIUM-SIZE JAPANESE BUSINESS DURING CURRENT MONTH. TRADING COMPANIES REPORT THAT WHILE LIQUIDITY POSITION NOW UNDER STRAIN, STILL SEEKING TO PREPAY IMPORTS TO THE EXTENT POSSIBLE AND DEFER CONVERSION EXPORT RECEIPTS AS LONG AS POSSIBLE. ONE TRADING COMPANY EXECUTIVE SURPRISED AT TODAY'S BOJ RATE ACTION. HAD THOUGHT RATE WOULD STABILIZE IN YEN 276-277 RANGE THROUGH INTERVENTION. FEELS CURRENT YEN 280 RATE REASONABLE BUT KNOWS OF OTHERS WHO BELIEVE RATE COULD DROP FURTHER AS EVIDENCED BY DEEP DISCOUNT ON FORWARD RATES. SUBSTANTIAL REMITTANCES TO OVERSEAS BRANCHES AND SUBSIDIARIES HAVE ALREADY BEEN MADE AND REMAINDER WILL HAVE TO AWAIT DEC CREDIT POSITIONS.

COMMENTS: RECENT INFORMATION CONFIRMS FINALL BELIEF (REPORTED LIMDIS GREENBACK TOKYO 14450) THAT MOF INTENTIONALLY GENERATED YEN DECLINE DURING PERIOD WHEN DOLLAR WAS STRENGTHENING IN EUROPE. MARKET WELL AWARE OF REVISED OFFICIAL B/P OUTLOOK THAT JAPAN ENTERING EXTENDED PERIOD OF "DEFICITS". MARKET CONSIDERS RATE ACTION CONSISTENT WITH "NEED TO FIND FINANCING" OF \$7 BIL DEFICIT BASIC BALANCE IN CURRENT CONFIDENTIAL

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FISCAL YEAR. HOWEVER, CHANGE IN MARKET PSYCHOLOGY GOT COMPLETELY OUT OF HAND. CLUMSY INTERVENTION AND RATE POLICY MERELY EXACERBATED MARKET SITUATION AND FORCED OFFICIALS TO LOOSEN A FEW FOREX CONTROLS ON CAPITAL INFLOWS IN AD HOC FASHION. TRADING COMPANIES REPORTEDLY INCREASING THEIR EXPORTS ESPECIALLY TO U.S. NOW THAT EXPORT RESTRAINTS HAVE BEEN TERMINATED. MANY EXPORTS BEING PRICED AT ASSUMED EXCHANGE RATE OF YEN 250 WHICH NOW REALLY YIELD YEN 30 ADDITIONAL PROFIT. THUS, CURRENT EXCHANGE RATE APPARENTLY CREATING ADDED PROFIT INCENTIVE FOR JAPANESE EXPORTS. TRAING COMPANIES, ON OTHER HAND, CAN EASILY PASS ON TO DOMESTIC CUSTOMERS HIGHER YEN COSTS OF IMPORTS. VERY FEW IF ANY IN TOKYO REALIZE POTENTIAL DOMESTIC IMPACT OF NEW EXCHANGE RATE AT AT IME WHEN VIRTUALLY ALL OPPOSING LDP FACTIONS BECOMING MORE CRITICAL OF TANAKA'S DOMESTIC ECONOMIC POLICIES WHICH SEEM UNLIKELY TO STEM EVER MORE SERIOUS INFLATIONARY SITUATION. SHOESMITH

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